FRBSF Weekly Letter

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Where Are Banks Going?

There was a time, the old joke goes, when banks followed the rule of 3-6-3. They borrowed at three percent, lent at six percent and closed at three p.m. Those days are gone forever. The business of banking is far more complicated today, due largely to economic, technological, and regulatory forces that are pushing the financial system in new directions.

At least three trends characterize the future of banking in this country. First, banks' role as funding intermediaries is diminishing and banks, instead, are taking on the role of broker and/or underwriter for credit transactions. Second, banks' formerly protected turf is being invaded by investment banks, thrifts, insurance companies, and even retail firms. In response, banks are expanding their activities into the domain of investment banks and insurance companies. Finally, banks also are expanding geographically as they compete in interstate and even international markets.

Declining bank intermediation

Historically, banks have provided a whole package of services as intermediaries between investors and borrowers. To investors, they have offered safe, diversified investment vehicles in the form of insured deposits. To borrowers, they have offered loans tailored to fit specific maturity and denomination requirements.

Banks performed these services because it was cheaper for investors and borrowers to deal with an intermediary than to deal directly with each other. Now, however, technological change, particularly the decline in the cost of processing and transmitting information, has reduced the value of banks' cost advantages as intermediaries.

As a result, many services that used to be offered by banks increasingly are being sold separately by different types of intermediaries or are being performed by investors and borrowers themselves. It is now more economical, for example, for investors to evaluate credit risk themselves by obtaining credit ratings from Moody's and Standard and Poors. By purchasing financial guarantees and/or investing in the liabilities of diversified pension funds, tax-sheltered savings plans, and mutual funds, they can diversify and reduce their exposure to credit risk even on small investments. Investors can manage interest rate risk by purchasing options and financial futures, and reduce liquidity risk by purchasing longer term debt securities that have active secondary markets.

Likewise, for well-known borrowers, it has become relatively less expensive to place debt obligations directly with investors. Moreover, it is possible even for lesser known, middle market borrowers to attract investors by obtaining financial guarantees from insurance companies and/or standby letters of credit from banks.

The growth of the commercial paper market is one manifestation of banks' diminishing role as funding intermediaries. Commercial paper outstanding in 1960 amounted to approximately one percent of the short-term debt of nonfinancial businesses. Now, commercial paper makes up six percent of short-term business debt. By contrast, business loans now account for only 63 percent, compared to 73 percent in 1960.

In addition to economic incentives that favor a smaller role for banks as intermediaries, regulatory restrictions such as reserve requirements and more stringent capital have been forcing changes in the way savings are channeled to borrowers. Reserve requirements make it more costly for banks to obtain funds to make loans. Moreover, tighter capital regulation has raised the cost of intermediation by requiring banks to hold more capital than they would have otherwise to back loans.

Underwriters and brokers

In response to these economic and regulatory incentives, banks frequently act as underwriters and/or brokers to facilitate transactions directly between borrowers and investors. For example, instead of funding loans to larger corporate borrowers, banks now, in effect, sell their expertise in credit evaluation and underwriting credit risk by offering standby letters of credit to back the marketable debt obligations of these borrowers.

For regulatory and other reasons, it may be less economical for banks to fund certain types of loans, such as mortgages and consumer credit. However, banks retain a comparative advantage in originating and servicing payments on these obligations. As a result, banks now sell or "securitize" loans they originate. "Securitization" refers to the process of pooling loans and using them as security for debt instruments that are then sold in the market.

Mortgage loans were the first to be securitized with the advent of the GNMA (Ginnie Mae) pass-through security in 1970. Since then, mortgage-backed securities have grown rapidly and now make up more than 20 percent of the $2.6 trillion in mortgage debt outstanding. In addition to residential mortgages, banks also are securitizing commercial mortgages, automobile finance loans, and credit card receivables.

Old roles

Although the role banks play as funding intermediaries is diminishing, it will not disappear entirely. Banks' ability to fund loans will continue to be important in at least two ways. First, banks will continue to make and hold loans that are not readily securitized. To make loan-backed securities marketable, securitization requires the standardization of loan terms and conditions. Similarly, it requires that investors be able to evaluate the credit risk of the underlying pool of loans at relatively little cost. Loans that require special knowledge of and expertise in local markets therefore are not easily standardized. To compensate lenders for the higher costs associated with making these nonstandard loans, their yields will rise relative to the yields on debt obligations that can be securitized. Consequently, banks will have incentives to continue to make and hold nonsecuritizable loans.

A second way in which banks will remain important as intermediaries is as back-up sources of liquidity when borrowers find it difficult and/or costly to raise funds in capital markets. For this reason, even the borrowers that have ready access to commercial paper and other direct securities markets still pay banks substantial fees to maintain lines of credit and loan commitments. Likewise, in international capital markets, borrowers have been attracted to the note-issuance and revolving underwriting facilities offered by banks. These facilities ensure access to funds at reasonable cost should the borrowers be unable to sell their notes directly to investors.

Breakdown of specialization

In addition to, and in part because of, the trend towards securitization and direct placement of debt obligations, institutional specialization is breaking down. Since the early 1930s, the business of banking has been legally separated from other types of business. With the passage of the Bank Holding Company Act in 1956, nonbank firms could not offer banking services through subsidiary banks and bank holding companies could not offer any services that were not closely related to the business of banking. However, innovations such as the money market mutual fund and repurchase agreements, the exploitation of legal loopholes such as the so-called "nonbank bank" loophole, as well as broader interpretation of regulations lately have blurred the boundaries separating the activities of banks and nonbanks. (A nonbank bank is a firm that skirts the legal restrictions on the ownership of banks by offering either deposits withdrawable on demand or commercial loans, but not both.)

Now, investment banks, thrifts, insurance companies, and even nonfinancial firms are offering banking services, while banks are offering nonbanking services.

Economic forces and the desire to avoid regulatory barriers are driving these changes. The declining cost of information technology, combined with both higher and generally more volatile interest rates, and legal restrictions on the payment of interest on demand deposits have transformed the way businesses and households manage their funds. As a result, it has become more advantageous to combine payments activity with investment and trading activity.

Securities firms, for example, now offer checkable money market funds that are functionally similar to transactions accounts offered by banks. Since transactions in these accounts still must be settled through a bank, securities firms and other nonbanks are seeking to acquire such bank-like firms as thrifts and nonbank banks to settle transactions directly. Currently, almost 50 nonbank banks owned by firms that are not affiliated with banks have accounts with the Federal

Reserve for the purpose of settling transactions. (However, the "Competitive Equality Banking Act of 1987" closes the nonbank bank loopholes.)

Banks also have responded to the incentives to integrate payments and investment activity. Many, for example, now offer discount brokerage services. With the growing reliance on direct placement among corporate borrowers, the larger banks have begun to make inroads into corporate securities underwriting as a logical extension of their loan underwriting expertise. The Federal Reserve recently allowed subsidiaries of several bank holding companies to underwrite commercial paper, but that ruling is being challenged in the courts. In international capital markets, where they are not as constrained by legal restrictions, banks underwrite a significant and growing proportion of securities.

Geographic expansion

As improved information technology, increasing reliance on direct placement and securitization, and the growth of interstate and international commerce have encouraged the integration of local markets with national and even international financial markets, banks have expanded their geographic reach.

Historically, banks were required by law to confine their deposit-taking activities to one state, and, in a number of states, to only one local market within that state (unless they act through nonbanking affiliates within the framework of a bank holding company). Forty-five states now have legislation permitting entry by banks located out of state. Many of these states permit, or will eventually permit, entry by banks headquartered anywhere in the country. To date, however, relatively few organizations have established extensive interstate banking networks under these laws.

With respect to international expansion, banks have been less constrained by branching laws. In fact, part of the reason the larger banks have expanded overseas is to avoid domestic regulation and to take advantage of international regulatory discrepancies. The London and Tokyo markets, for example, have become more attractive to U.S. banks because they have loosened restrictions on the activities of participants and allowed greater integration of commercial and investment banking.

Looking ahead

To sum up, banks appear to be going in a number of new directions. Due to the decreased cost of processing and transmitting information, among other things, banks are losing their competitive advantage as funding intermediaries, and borrowers are placing debt directly with investors. Banks are responding by securitizing loans and selling standby letters of credit in support of securities transactions.

This rise in direct placement and securitization has made the integration of banks' payments services with investment banks' securities underwriting and distribution services more attractive. As a result, this country eventually may have full-service banks that combine investment and commercial banking in one organization (although perhaps not in the most efficient form if present laws are not changed).

Finally, as financial markets are becoming increasingly national and international in scope, banks are expanding their activities geographically. In time, there will be banks with nationwide branch networks.

These developments do not necessarily imply that only big banks will remain, or that all banks will be full-service banks in the sense described here. Loan securitization affords smaller banks the opportunity to purchase a diversified portfolio, thereby enabling them to continue making loans in the local markets in which they have expertise. Most banks will continue along familiar roads and offer traditional banking services, but the overall growth in lending by banks may slow and the good old days of 3-6-3 will be gone.

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Editorial comments may be addressed to the editor (Gregory Tong) or to the author .... Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 9/2/87	Change from 8/26/87	Change from 9/3/86 Dollar	Change from 9/3/86 Percent[7]
Loans, Leases and Investments[1 2]	205,482	865	493	0.2
Loans and Leases[1 6]	181,708	654	– 3,742	– 2.0
Commercial and Industrial	51,180	135	– 46	0.0
Real estate	69,640	– 224	2,499	3.7
Loans to Individuals	37,126	– 41	– 4,152	– 10.0
Leases	5,415	– 8	– 115	– 2.0
U.S. Treasury and Agency Securities[2]	16,826	236	5,224	45.0
Other Securities[2]	6,948	– 24	– 991	– 12.4
Total Deposits	207,534	4,455	– 4,838	– 2.2
Demand Deposits	52,949	3,684	– 3,436	– 6.0
Demand Deposits Adjusted[3]	36,400	1,356	– 15,252	– 29.5
Other Transaction Balances[4]	20,291	617	2,447	13.7
Total Non-Transaction Balances[6]	134,293	153	– 3,850	– 2.7
Money Market Deposit Accounts—Total	44,905	316	– 2,386	– 5.0
Time Deposits in Amounts of $100,000 or more	31,169	– 222	– 4,115	– 11.6
Other Liabilities for Borrowed Money[5]	23,977	– 1,333	– 2,732	– 10.2

Two Week Averages of Daily Figures	Period ended 8/24/87	Period ended 8/10/87
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	186	32
Borrowings	24	12
Net free reserves (+)/Net borrowed(–)	162	19

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change